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TAGS: ECON EFIN EIND EINV ETRD EAGR IN
SUBJECT: FOREIGN INVESTORS CHASE INDIAN ECONOMY'S GOOD NEWS BUT WEAK IT SECTOR AND A MISSING MONSOON COULD SPELL FUTURE TROUBLE

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¶1. (SBU) Summary: According to investors and finance professionals in Mumbai, economic sentiment in India is on the upswing. Key indicators, including rising capital markets, corporate earnings, and manufacturing indices confirm this belief. Foreign institutional investors (FII) are returning to India, bringing with them much-needed cash infusions to the capital markets. In addition, domestic companies have raised almost $8 billion from foreign and domestic investors in recent months, after almost a year of poor prospects. Certain sectors, however, remain in precarious positions. The IT industry, which largely served U.S. markets and the financial services industry, projects a severe drop in earnings growth. The agricultural sector, too, is likely to suffer from a weak monsoon season, with rainfall levels hovering approximately 20 percent below average, barely above drought level. Despite continued public spending on rural development, low agricultural outputs may lead to consumer inflation and lowered GDP growth, further stumbling blocks on the road to economic recovery. End Summary.

Foreign Investors Put Their Money on India

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¶2. (U) According to market participants, corporates, and economists, the Indian economy is seeing a renewal of investor confidence and a rise in economic sentiment. The Bombay Stock Exchange's SENSEX - a barometer for Indian stock market performance - stands at around 15,900, approximately the level it was in June 2008, and up 90 percent from late-November 2008. Volumes on the derivatives market have doubled since March 2009. A number of large Indian companies have posted better than expected corporate returns for Q1 2010 (average profits were up 23 percent, y-o-y), including auto and motorcycle manufacturers, buoying stocks prices. The purchasing manufacturer's index (PMI) shows an increase in manufacturing orders, consumer demand remains strong, and there is strong liquidity in the banking

sector with deposit growth outpacing credit growth. Exports are still contracting, though the pace has slowed.

¶3. (SBU) Tushar Poddar, Chief Economist for Goldman Sachs, believes that the Indian economy turned the corner in mid-May, when key indicators - specifically credit growth, industrial production, money supply, consumer spending, and housing loans - either stopped declining or turned modestly positive. Corporate earnings for Q1 2010 have been surprisingly good, indicating that many companies have weathered the worst of the crisis, cleaned up or restructured some of their debt now that conditions are more favorable, and benefitted from continued rural spending. Investors have returned to India, he observed, because it is one of the few growth stories at the moment. Poddar predicts 6 percent growth for India in 2009, making it one of the world's fastest-growing economies.

¶4. (SBU) Similarly, Sidharth Punshi, Managing Director and Country Head of investment bank Jeffries, also attributed increased foreign institutional investor inflow to unexpectedly strong first quarter corporate results, as well choice indicators, such as a 12 percent increase in car sales. He highlighted the fact that large companies such as Tata Steel, Tata Power, Suzlon, and Sterlite, among others, have raised almost $8 billion since March 2009, $7 billion of that from FIIs. The recent Adani Power IPO was oversubscribed by 20 times, demonstrating that there is now demand for new equity in the market after almost a year of inactivity. He also pointed to major real estate and infrastructure companies, such as housing giant DLF, who have retired some of their debt, sold assets and land, and largely avoided the major defaults that



many expected would be the "next shoe to drop" in the financial crisis' impact on India. He expects this investment trend to continue, with Indian companies raising approximately $20 billion by year's end.

¶5. (SBU) Bharat Doshi, the Chief Financial Officer of Mahindra & Mahindra, agreed, noting that now is an excellent time to raise funds in India, either through capital markets or other investment avenues. In June, Mahindra raised almost $100 million for Mahindra Holidays, a travel and resort company. Doshi said that because international borrowings were still expensive compared to domestic borrowing rates, and the banking system is flush with funds, Indian corporates would likely increase their domestic funding operations. Some small and medium-sized companies would still have problems getting credit due to continued risk aversion, but top-line corporations would be able to borrow at affordable rates. For Mahindra, the large increase in rural spending over the past year has contributed to a 40 percent growth in tractor sales, year-on-year. He feels that sales will continue to be high at least through October, when the impact of decreased government spending and the disappointing monsoon will be felt.

¶6. (SBU) India Capital Research Service's Managing Director, Dan Tennebaum, also reports a rise in foreign institutional investment citing net $6.5 billion FII investment since the Indian elections in May 2009 (versus net $13 billion of outflows in 2008). However, Tennebaum does not link increased investment to market fundamentals or recovery of the Indian economy. Rather, he thinks that developed markets present such a grim picture to investors that the Indian market--soft earnings and government inaction on economic reforms aside--appears attractive by comparison. He also cited increased FII appetite for risk as developed economies tended toward stabilization. Gopal Jain, managing partner of private equity firm Gaja

Capital, affirmed that FII inflows were returning to 2006-07 levels. However, he believed that the source of the inflows was a dollar-carry trade, as investors borrowed cheaply in the U.S. and reinvested in high-yielding emerging markets like India. While this benefits investment in the short-term, he worried that these investments could unwind suddenly if more financial problems develop in the U.S.

IT Sector Struggles to Find Good News

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¶7. (U) Despite the overall economy's turn for the better, important sectors continue to suffer. The Information Technology and Information Technology-Enabled Services (ITes) sector, a major driver of growth in the Indian economy, recorded 13 percent growth in 2008-09, significantly lower than the 30 percent growth recorded 2004-08. While export revenues grew by 16.3 percent during the year, almost all of the growth was witnessed before October 2008, when effects of the global slowdown first reached India. Sangita Gupta, Research Associate with the National Association of Software & Service Companies (NASSCOM), reports export revenues either contracted or were flat after September 2008. Since the U.S. market and global financial services sector comprise 60 percent and 40 percent of the sector's export revenues respectively, the double impact of the U.S. recession and the global financial crisis have hit the Indian IT sector hard. NASSCOM estimates that growth during the first half of 2009-10 will be flat or negative and will only marginally pick up in the second half of the year, leading to an overall growth rate of 4-7 percent for the sector in 2009-10. Going forward, Gupta said that this industry had already matured significantly, and 30 percent growth levels are unlikely to be sustainable, in any case.



Weak Monsoon Has Potential to Erode Recent Economic Gains

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¶8. (U) A weak monsoon is currently one of the clearest, if not biggest, threats to the Indian economy. Rainfall levels in June were approximately 35 percent below average, leaving India teetering on the cusp of having an officially "deficient" monsoon (defined as rainfall more than 19 percent short of average). Rainfall levels over the next few weeks will determine whether normal conditions or drought prevails; steady rains in August could elevate the monsoon into the "normal" range. The lack of rain, however, has already led to an 8.5 percent decrease in agricultural sowing - mainly affecting the rice crop in the crucial growing states of Andhra Pradesh, Uttar Pradesh, and Punjab - putting the effects of a weak monsoon already in motion.

¶9. (U) The results of a poor harvest could have rippling effects throughout the Indian economy. While agriculture only accounts for 16 percent of total Indian GDP, roughly 60 percent of Indians live and work in rural areas. The last weak monsoon was in 2002-2003, where a 19 percent deficiency contributed to a 2 percent drop in overall GDP growth. A Citibank report estimates that negative agriculture growth will, at a minimum,

decelerate GDP growth from 6.8 percent to 5.8 percent, despite governmental buffers such as the National Rural Employment Guarantee Scheme (NREGS), farm subsidies, and other fiscal interventions. UBS researchers estimate that GDP growth could fall 1.2 percent from their current 7 percent estimate, if rainfall does not improve. However, other economic forecasts suggest any decline will largely be compensated by other areas of the economy.

¶10. (SBU) Many observers fear that a poor harvest will lead to food price inflation, as poor harvests drive up commodity prices and spur rural unemployment. While the Wholesale Price Index (WPI), India's most data-reliable measure of inflation, is currently negative, the food portion of the basket, led by sugar, is positive. The more inexact - but more representative - Consumer Price Index (CPI) is already above 10 percent, reflecting a rise in food prices generally. Inflation, which Credit Suisse estimates will stand at 6 percent by early-2010, could have a strong dampening effect on the economy. Mumbai has already seen public demonstrations in the past few weeks over the rising prices of food goods, especially vegetables.

¶11. (SBU) Comment: A series of positive economic indicators has turned investor and market sentiment positive, at least in Mumbai. Good corporate earnings and the rebounding of capital markets have excited financiers and investors, although economists and Indian officials remain anxious about the impact of the so-far weak monsoon. While agriculture makes up an increasingly small part of overall GDP, a poor monsoon would have a disproportionate impact on the majority of India's mostly poor population, including a rise in basic food prices, more rural unemployment, and more defaults and impoverishment in the countryside. The Indian government will likely hew to election promises and continue to boost rural stimulus spending to stave off the most dire results, placing other economic reforms on the back burner. Nevertheless, this spending - much of it necessary, some of it wasteful - is already having an impact on the growing fiscal deficit, raising further long-term concerns about the economy. End Comment.
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